The Airline Business Model

Heading towards virtualization or integration

"Heading towards virtualization or integration" implies a strategic choice between two, metaphorical directions: on the one hand the direction of virtualisation, where the airline separates non-essential activities from the core activity. On the other hand the direction of integration where the airline groups those non-essential activities with the core activity. Rigas Doganis, author of the book "The airline industry in the 21st century", refers to a virtual airline model and an aviation business model respectively. The aim of this thesis, based on those two models, is to find out if there are any competitive differences as a result of contrasting approaches by airlines towards the defining of this core activity. In attempting to realise this aim I had to ask myself two key questions: What is this core activity? And do different approaches in defining this core activity affect the competitive climate in the airline industry?

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Which interpretation should be given to a core activity? Based on the core competence theory of Prahalad and Hamel, together with other, different economical approaches towards this theory, I created a core competence checklist. This checklist gives, based on nine criteria/conditions, a further insight into the concept of the core competence. The core activity, assumed in this thesis, is created out of the available core competenc(i)e(s): the realization of these core competencies will lead to core products. The creation of these core products gives an organisation direction in defining those activities it thinks are most essential. Regarding this thesis, it should be asked which specific activity an airline thinks is most essential. At this important stage I disagree with the assumption Doganis made by regarding the so-called 'flight operations' as the airlines' core activity. I believe the rationalisation and exploitation of the 'physical' transport network should be the most essential activity undertaken by each airline. Network management is the core of each airline organisation. This belief is based on two conditions; the dynamics of the airline industry make effective network management a necessity for airlines. In this case important issues are; the growing difficulties in obtaining the right slots at airports and the changes in the environment airlines are currently operating in - such as regulations, new entrants and new alliances. The availability of a network and / or effective network management is not the only issue. An airline needs the necessary insights into the marketing implications that a network has - specifically: the so called hub-and-spoke network. There are synergy effects between the aviation-related marketing instruments in a hub-and-spoke network. Examples are; the positive interrelations between code sharing, frequent flyer programs and global distribution systems.
On this point, upon which I stated effective network management as the most essential activity, an airline will decide if it will expand or narrow the scope of core activities. At this stage a link is made between the two business models postulated by Doganis: scope expansion and integration, are shown in the aviation business model where narrowing of this same scope, outsourcing, is shown in the virtual airline model. This last model particularly, implies the existence of 'organisational' networks: networks between the outsourcer (the airline) and the different suppliers. In my thesis, the creation of these networks is explained from a core competence point of view. Another view on this issue is that outsourcing activities normally take place when the costs to do this are lower than the internal costs (from a transaction costs viewpoint). The two business models represent the framework in which this investigation takes place. Taking this into account does not mean that I ignore the existence of (more obvious) intermediate models. On the contrary, the continuum of virtualization serves as a guideline: virtualization represents the degree of outsourced activities by an airline. A low degree implies that less or no activities, apart from the most essential activity, are being outsourced. However, a high degree implies that almost all activities are being outsourced.

This theoretical knowledge gives me the opportunity to study four airlines, in the course of which, in order to answer the above question I must pose two further questions: which activities are organised in what way and which are part of the organisational framework? Secondly, what is the highest degree of virtualization based on this study and in what way does it correspond to the theory? The choice of an airline to organise activities internally or in another way is based on two conditions, the actual aim (priorities) an airline has and the available core competencies. In this thesis I defined four possible structures: activities which are part of the internal organisation; activities which are formed by means of a unique outsource relation; activities which are formed by means of a profit centre or activities that are executed by suppliers because those activities aren't part of the organisation. British Airways, as part of this airline study, only allows a small amount of activities to be executed by specialised suppliers and integrates all the other activities in different ways. This means that

network management, e-commerce activities and the so-called leisure activities are all part of British Airways' internal organisation. Cargo, engineering and consulting activities are all formed under three separate profit centres. They do not only serve British Airways but also other organisations. Finally catering (Gate Gourmet and ALPHA Catering) and the ground services are those activities that are executed by the specialised suppliers.
The mixed-model form British Airways uses, can also be found in the way in which KLM organises its activities. 'Passage' and 'E-commerce' are part of the internal organisation. Cargo activities as well as 'Engineering & Maintenance' and ground services are liberalised as profit centres. Like British Airways, catering is outsourced. This also counts for handling services.
The organisational framework of Lufthansa shows the most similarities with the aviation business model proposed by Doganis. The 'Passenger Business' should be viewed as the most essential activity. Together with the underlying network and its rationalisation and exploitation this business unit is the core of the Lufthansa Group. The passenger business unit is, like the other six business units within the group - Logistics; Maintenance, Repair & Overhaul; Catering; Leisure Travel; IT & Consulting Services and Ground Services - a specialised and profit seeking company. Those six business units not only serve units within the Lufthansa Group, they also function as external suppliers. This means that each unit has its own specialised market.
Finally, in studying Ryanair's organisational structure I have found that, as a result of the high degree of virtualization, by means of outsourcing activities to external suppliers, Ryanair is capable of creating and sustaining relatively lower cost levels. This explains the choice for the 'low cost-no frills' airline in this thesis. Soon it became clear Ryanair is not a complete virtual airline but more a near virtual airline: Ryanair's multi-base network (the secondary airports of Dublin, Shannon, Glasgow Prestwick, London Stansted, Brussel Charleroi and Frankfurt Hahn serve as mini-hubs) as well as its IT-services should be viewed as essential parts of the internal framework. Cost reductions are normally created by outsourcing activities, like maintenance, materials & repair, ground services and catering.

In conclusion, based on these four small airline studies, a network and its rationalisation and exploitation need to be viewed as the most essential part of an airline, THE core activity. It also needs to be said that, apart from the Lufthansa study, e-commerce activities form an important part of the internal organisation. I like to call those activities the 'kerosine of a virtualization process'. These activities give airlines, notably not only the low cost airlines, the chance to simplify, accelerate and even eliminate (most) critical and operational processes. In this way airlines can attempt to reduce their cost levels. Obviously competitive differences will arise. What is important is that a specific airline should recognise the critical link between the exploitation of e-commerce and the degree of virtualization. This could result in a smaller activity-base. However, to what extent does the model of the near- virtual airline preserve itself during an economic recession? In other words: is there an economic basis that could compensate for the financial losses during a recession? The answer to this question can only be found by looking more closely at the use of the aviation business model. It is said that the use of this model has the advantage that it protects an airline from the cyclical character of the aviation industry because there will be a leverage effect between the core activity and the activities not related to this core activity. But is this true? Normally those less essential activities will be, to a certain degree, related to the core activity, which means that a loss in the core activity is much more difficult to compensate for. The presence of less essential activities (aviation business model) or the lack of it (virtual airline model) does NOT guarantee compensation for losses in the core activity. The economic basis is fragile.
Competitive differences could arise as a result of virtualization differences between airlines: a high degree of virtualization could lead to lower cost levels which, in its way, has an impact on prices. A low degree (read: a high degree of integration) could lead to a better monitoring of these cost levels. This could indirectly have a positive effect on the prices as well.
A second cause can be found in the efficiency of price agreements: the use of a virtual airline model implies a free choice of suppliers, which, in turn will automatically lead to more efficient price agreements. This in comparison with the inefficient price agreements in airlines who use the model of the aviation business, which means they have to depend on 'fixed' suppliers.
A third cause comes from the separate profit centres in the aviation business model. Competitive differences could arise as a result of economies of scale the separate profit centres have. This could lead to higher and stronger competitiveness and so realisation of more efficiency.

It needs to be said that, based on the four airline studies, the difficulty lies in recognising and defining the competitive consequences as a result of an unequal defining of the core activity or activities. Another difficulty lies in the comparison of British Airways and KLM: two airlines in this thesis that show the most similarities. Usually, just as in this thesis, the framework has been created by two 'extremes', Lufthansa and Ryanair.